IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

In Re ENRON CORPORATION SECURITIES, DERIVATIVE & "ERISA" LITIGATION,	§	MDL 1446
MARK NEWBY, ET AL., Plaintiffs VS. ENRON CORPORATION, ET AL., Defendants	§	CIVIL ACTION NO. H-01-3624 AND CONSOLIDATED CASES
SILVERCREEK MANAGEMENT, INC. ET AL., Plaintiffs, VS. SALMON SMITH BARNEY, INC., ET AL., Defendants.	§	CIVIL ACTION NO. H-02-3185

MEMORANDUM AND ORDER OF PARTIAL DISMISSAL

Pending before the Court in H-02-3185, transferred from the United States District Court in the Southern District of New York by the Panel on Multidistrict Litigation for consolidation with MDL 1446, are the following motions:

(1) Defendant Goldman, Sachs & Co.'s ("Goldman, Sachs'") motion to dismiss the complaint for failure to state a claim for which relief can be granted and failure to plead with particularity, or alternatively, to compel arbitration of the two common law claims (instrument #7);

1846

(2) Defendant Salomon Smith Barney, Inc.'s motion for an order to dismiss for failure to state a claim upon which relief can be granted (#10);

(3) Defendants Banc of America Securities LLC's ("BA's") motion to dismiss complaint with prejudice (#14);

(4) Goldman Sachs' motion for leave of court to supplement the record in support of its alternative motion to compel arbitration by filing the affidavit of Kim Cuomo, which is submitted to authenticate the account agreements giving rise to Goldman Sachs' alternative motion to compel arbitration (#1312 in *Newby*; #62 in H-02-3185).

This suit, H-02-3185, in essence arises out of the same pyramid scheme alleged in great detail in *Newby*, in particular the illicit special purpose entities controlled by Enron and utilized for undisclosed off-the-books transactions involving sham hedging and loans disguised as sales that materially distorted Enron's reported financial results in financial statements prepared by and continually supported by Defendants here and thereby defrauded Enron investors, including Plaintiffs Silvercreek Management Inc., Silvercreek Limited Partnership, Silvercreek II Limited, Onex Industrial Partners Limited, and Pebble Limited Partnership.

Plaintiff Silvercreek Management, Inc. represents that it "is an institutional money manager, and the other Plaintiffs are investment entities for which Silvercreek Management serves as an investment manager." #28, citing ¶¶ 8-12 of the original complaint. Plaintiffs' initial complaint states that they purchased over $175 million in Enron debt securities during October 2001, just before Enron's crash, and lost approximately $122 million as a result. The complaint asserts that Defendants participated in, conspired with other wrongdoers, and aided and abetted in the wrongful conduct comprising the fraudulent scheme.

The motions to dismiss relate to the original complaint (#1), which specifically asserts (1) against Salomon Smith Barney, Goldman Sachs and BA (collectively, "the underwriter Defendants") common law claims for "fraud and deceit" and for negligent misrepresentation, under New York law, as well as violations of Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k, relating to Enron 7% Exchangeable Notes; and (2) against Defendant Salomon Smith Barney, Section 11 claims relating to Enron Zero Coupon Notes. That original complaint has since been superseded by stipulation (#65) by Plaintiffs' first amended complaint (#61), which adds causes of action for violations of 15 U.S.C. § 10(b) and Rule 10b-5, 17 U.S.C. § 240.10b-5, and of 15 U.S.C. § 20(a) of the Securities Exchange Act of 1934, and violations of Article 81-1 of the Texas Securities Act, extends its section 11 claims relating to the Zero Coupon Notes to all three Defendants, and provides more detailed factual allegations about the underwriter

Defendants' involvement in the alleged fraudulent scheme.[1] Another original Defendant, Arthur Andersen LLP, Enron's outside auditor and certifier of Enron's financial statements with unqualified audit opinions that were filed directly with the SEC and that were also later incorporated by reference into Enron's registration statements for both note offerings at issue, has not moved to dismiss any claims against it or its officers and employees. For these reasons the pending motions to dismiss are actually for partial dismissal of causes of action against the three underwriter Defendants.

In particular the original complaint alleges that Salomon Smith Barney, Goldman Sachs, and BA served as underwriters on Enron's July 1999 public offering of 7% Exchangeable Notes,[2] which were mandatorily exchangeable into Enron common stock of

[1] The new section 10(b)/Rule 10b-5 and § 20(a) claims are brought against the entity that Salomon Smith Barney has now become, Citigroup, Inc./Salomon Smith Barney (a subsidiary of Citigroup, Inc.), and against Goldman Sachs, while the claims under the Texas Securities Act are asserted against all Defendants.

[2] According to the complaint, the prospectus and Form S3 registration for the 7% Exchangeable Notes was filed on July 23, 1999, followed by amendments on August 2 and 10, 1999. These contained financial data consistent with statements previously filed with the SEC by Enron regarding its financial results for 1997, 1998, and the first quarter of 1999, and they incorporated by reference Enron's quarterly and annual financial statements that had been reviewed by and given unqualified audit opinions by Arthur Andersen LLP, Enron's auditor, even though it knew these financial statements were false and misleading. The underwriters of the 7% Exchangeable Notes were Goldman Sachs, Salomon Smith Barney, and BA.

Enron's partially owned subsidiary, Enron Oil & Gas Company.[3] The underwriter Defendants also served as initial purchasers of Zero Coupon Convertible Senior Notes, debt securities that were convertible into Enron common stock, offered beginning in June 2001,[4] shortly before Enron was forced to restate its financial results for the previous four years.[5] Plaintiffs purchased their 7% Exchangeable Notes between October 24-26, 2001.

The initial complaint alleges generally that Defendants Goldman Sachs, Salomon Smith Barney, and BA were underwriters for Enron's multiple securities offerings for a number of years and that they participated in the two note offerings at issue, the 7% Exchangeable Notes and the Zero Coupon Notes, and in other wrongful financial transactions for Enron and its subsidiaries and affiliates. They allegedly reviewed the purportedly materially false financial statements and prospectuses filed with the SEC on

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[3] Enron Oil and Gas later became EOG Resources, Inc., now an independent public company. First Amended Complaint at 29, ¶ VII.A.1.

[4] The private placement for the Zero Coupon Notes issued on February 7, 2001 and the Notes were publicly offered in June 2001 after Enron filed a preliminary prospectus and registration statement Form S3 on the first of that month, followed by amendments in July, followed by supplements dated up to October 12, 2001. These filings contained financial data in accord with, and incorporated by reference, Enron's previously filed financial statements, which had been audited and certified by Arthur Andersen. Citigroup/Salomon Smith Barney was the lead underwriter.

[5] In the first amended complaint, Plaintiffs did not allege that Goldman Sachs was an initial purchaser of the Zero Coupon Notes offering. In the amended complaint Plaintiffs contend that Goldman Sachs was a statutory underwriter of the Zero Coupon Notes offering. The amended complaint further charges that Goldman Sachs and BA were statutory underwriters and initial purchasers of the Zero Coupon Notes offering.

Enron's behalf during 1999 and 2001, on which Plaintiffs claim they primarily relied in deciding to purchase the Enron debt securities at issue. According to the original complaint these "Wall [S]treet firms provided the financial grease which let Enron grow into the Nation's seventh largest company, and in the process these firms earned $214 million in underwriting fees alone, and much more for lending, derivatives trading and merger advice." #1 at 1-2. The underwriter Defendants, despite having full access to Enron's records, allegedly failed to perform adequate due diligence that would have uncovered Enron's fraud and Enron's deceptive financial statements, certified by co-conspirator Arthur Andersen LLP, nor did they adequately disclose the risks of the purchase of the notes to Plaintiffs. Moreover the complaint charges that because Defendants' brokerage personnel were directly involved in selling the Enron debt securities to Plaintiffs, the underwriter Defendants also breached "heightened fiduciary obligations to Plaintiffs." *Id.* at 2. Furthermore, even as Enron was imploding, the underwriter Defendants continued to recommend that Plaintiffs and the public purchase the notes at issue.

The Court first addresses Goldman Sachs' motions. Because the Court finds no prejudice to Plaintiffs Silvercreek Management Inc., Silvercreek Limited Partnership, Silvercreek II Limited, Onex Industrial Partners Limited, and Pebble Limited Partnership from allowing Goldman Sachs to supplement, and because Plaintiffs in their opposition (#64) have not argued there is any, the Court grants the motion to supplement (#62) with Kim Cuomo's affidavit.

As its first ground for dismissal, Goldman Sachs contends Plaintiffs' initial complaint fails to adequately plead reliance, an essential element of common law fraud and negligent misrepresentation and of Plaintiffs' § 11(a) claim against Goldman Sachs. Instead, insists Goldman Sachs, Plaintiffs have merely asserted a single, bare-bones, conclusory allegation of reliance, which is insufficient. Section 11(a) itself requires a showing of actual reliance rather than presumed reliance after a twelve-month period following the effective date of the prospectus and registration statement. Moreover, Goldman Sachs maintains that Plaintiffs' factual assertions that they "read, reviewed and relied upon" Enron financial statements for 2000 and 2001 (Complaint at ¶ 152), as well as the nature of Plaintiffs' business in trading in distressed securities, their arbitrage strategy, and their purchase of the Enron debt securities after publicized negative news about Enron, negate any claim of justifiable reliance on the old 1997 and 1998 financial statements by Plaintiffs as a matter of law.[6] Goldman Sachs cites New York

[6] Goldman insists that any claimed reliance on Enron's three-to-four-year-old financial misstatements, incorporated into a prospectus and registration statement, was irrelevant because of Plaintiffs' arbitrage trading strategy, which required up-to-the-minute market information. In its memorandum (#8 at 13-14), Goldman Sachs identifies the nature and date of various negative, publicized events relating to Enron before and during Plaintiffs' purchases of the Exchangeable Notes that Goldman Sachs argues defeat any assertion of justifiable reliance in view of the trading strategy they employed. For example, Goldman Sachs emphasizes that by the time Plaintiffs purchased about 500,000 Zero Coupon Notes on November 28, 2001, Enron had already announced on November 8, 2001 that it was restating four years of financial statements, had advised the public that none of those financial statements should be relied upon, and had announced on October 22, 2001 that the SEC was informally investigating Enron's

case law concluding that where plaintiffs are "sophisticated businessmen," as Goldman Sachs characterizes Plaintiffs here,[7] a

accounting practices, and the SEC's formal investigation actually began on October 31, 2001. Furthermore the first securities class action lawsuits were filed against Enron and Andersen on October 22, 2001 and the first shareholder derivative suit against Enron on October 23, 2001. Andrew Fastow was fired on October 24, 2001. The very day that Plaintiffs were purchasing their notes on November 28, 2001, Enron's debt was downgraded to "junk" status and its common stock had plummeted to $.69 per share.

[7] To demonstrate that Plaintiffs were highly sophisticated traders, Goldman Sachs charges that Plaintiffs "were engaged in a complex arbitrage strategy based on contemporaneous Enron news," i.e., "taking advantage of temporary, often fleeting price differences in separate but related markets . . . for notes and for equity into which the notes are exchangeable"; indeed Goldman Sachs contends that "while plaintiffs were buying Exchangeable Notes . . ., they were simultaneously selling short the common stock of Enron Oil & Gas into which the Exchangeable Notes were convertible," a fact they omitted from the complaint but which is evidenced in their trading records that may be considered for purposes of the motion to dismiss. #8 at 14-15. Trading records or transactions with Salmon Smith Barney are found in Exhibits A-E to the Affidavit of Richard A. Rosen (#19)with BA, Exs. A-D to the Affidavit of Gregory A. Markel submitted in response to BA's motion to dismiss (#14). Indeed, BA charges that Plaintiffs' failure to disclose this short-selling of Plaintiffs' EOG stock for profit because of the downturn in Enron's stock price during October and November renders their claims for damages deficient.

The Court observes that Plaintiffs' first amended complaint at 38-39, ¶ 107, asserts that they

> were not buying distressed securities. They were buying senior bonds of a BBB+ highly rated company. Plaintiffs' investments were--or should have been--relatively low-risk yield-oriented trades. . . . . To be successful, all that was required was that the company stay solvent-which, at the time that investments were made, seemed certain. However, the financial information in the prospectuses did not reflect the company's true condition.

Furthermore Plaintiffs have submitted the affidavit of Louise Morwick (#29), President of Silvercreek Management Inc., which states that

> Silvercreek invests primarily in convertible securities and employs a strategy that focuses on cash flow and the fundamental valuation of companies. Silvercreek invests in convertibles, but does not engage in the delta hedging arbitrage strategy employed by most convertible arbitrage investors. Silvercreek is <u>not</u> a "vulture/distressed" investor as claimed in the defendants' motion papers. Silvercreek does <u>not</u> specialize in the purchase of distressed or troubled debt. . . . Silvercreek's purchases of Enron Zero Coupon Notes . . . and Enron 7% Exchangeable Notes . . . were part of the two key components of Silvercreek's investment strategy: (i) its outright bond portfolio, and (ii) its fully hedged yield portfolio.

Morwick explains that the portfolio of outright long convertible bonds targets yield oriented investments, which provide a positive return as long as the company remains solvent and the added benefit of being convertible into common stock equity if the value of the company's common stock increases. Thus, she maintains, it is a more conservative investment than simply buying a company's equity. The Zero Coupon Notes were part of this portfolio.

The fully hedged exchangeable bond portfolio is also comprised of yield oriented investments, and included the 7% Exchangeable Notes. The notes were to mature in July 2002, at which time Enron was contractually obligated to deliver a minimum of .8475 EOG shares per note. According to the affidavit, to fix the minimum principal amount and to lock in a return, Silvercreek sold .8475 EOG shares at the same time it purchased the Exchangeable note in order to fix a price for the EOG shares to be received at maturity and eliminate market risk on the value of EOG common stock; without the sale, the value of the 7% position would fluctuate with the value of EOG and be a more risky investment. In the absence of an Enron bankruptcy (the only real risk and the factor which made credit information about Enron critical), the combined trade locked in a minimum low risk return over approximately nine months until maturity, according to her explanation.

Morwick represents that at the time Silvercreek invested in both notes, Enron was highly regarded by Wall Street analysts, enjoyed a BBB+ investment grade credit, had a multi-billion dollar equity market capitalization and a track record of stable financial performance. Since the investment was in senior bonds, not distressed securities, Enron would have to lose at least $20 billion of equity value before the investment was impaired. Thus Enron had only to remain solvent until July 2002 for their investment to be successful.

Moreover, regarding some Enron securities trades that claim of justifiable reliance on three-to-four-year-old financial statements is undermined as a matter of law. *See, e.g., In re Livent, Inc. Noteholders Sec. Litig.*, 151 F. Supp. 2d 371 (S.D.N.Y. 2001); *Grumman Allied Indus., Inc. v. Rohr Indus. Inc.*, 748 F.2d 729, 737 (2d Cir. 1984); *Stuart Silver Assocs. v. Baco Dev. Corp.*, 665 N.Y.S.2d 415, 417-18 (1st Dep't 1997).

Insisting that the entire complaint "sounds in fraud," Goldman Sachs also moves to dismiss for failure to comply with the requirement of Fed. Rule of Civil Procedure 9(b) that a plaintiff plead with particularity. Goldman Sachs maintains there are no particularized allegations of fraud (alleged fraudulent statements, speaker, when and where the statements were made, and why the statements were fraudulent when made) against it, nor of allegations of conspiracy, aiding and abetting, and common course of conduct. It also emphasizes that the complaint does not allege that Goldman Sachs underwrote the Zero Coupon notes or had any communications with Plaintiffs about their Enron trades. Nor do their allegations support scienter, i.e., Plaintiffs fail to assert facts creating a strong inference of fraudulent intent. Even the charge that Defendants should have uncovered the alleged wrongdoing by due diligence is conclusory and insufficient to satisfy Rule 9(b), argues Goldman Sachs.

Goldman Sachs also contends that Plaintiffs have failed to allege any misrepresentation or omission by it or to show a

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Defendants contend Plaintiffs failed to disclose, Louise Morwick states that, not Plaintiffs, but she, personally, bought notes in November 2001 for her own account.

duty on the part of Plaintiffs to speak and/or disclose, to support Plaintiffs' claims of fraud or negligent misrepresentation.

Finally, Goldman Sachs incorporates the arguments of Salomon Smith Barney and BA, which in essence duplicate its own with respect to the claims asserted against each; they in turn adopt Goldman Sachs' objections.

Alternatively, argues Goldman Sachs, if the Court does not dismiss Plaintiffs' common-law claims for fraud and negligent misrepresentation, they should be compelled to arbitrate them pursuant to identical arbitration clauses ("[a]ny controversy . . . arising out of or relating to this agreement, the transactions contemplated hereby, or the accounts established hereunder, shall be settled by arbitration . . . .") in Plaintiffs' customer agreements with Goldman Sachs under the Federal Arbitration Act, 9 U.S.C. § 4. See agreements attached to Affidavit of Kim Cuomo (#63). Indeed, for a negligent misrepresentation claim, Goldman Sachs maintains, a plaintiff must allege a fiduciary or other "special relationship" with the defendant; here, if at all, such a relationship could only be created by the customer relation agreements between Plaintiffs and Goldman Sachs. *See, e.g.*, *Congress Fin. Corp. v. John Merrell & Co.*, 790 F. Supp. 459, 474 (S.D.N.Y. 1992); *Murphy v. Kuhn*, 90 N.Y.2d 266, 271 (1997)(liability for negligent misrepresentation may only be imposed on "those persons who possess unique or specialized expertise, or who are in a special position of confidence and trust with the injured party such that reliance on the negligent misrepresentation is justified").[8]

The other Underwriter Defendants' motions to dismiss present arguments largely overlapping those in Goldman Sachs' motion. Salomon Smith Barney moves for dismissal on the grounds that Plaintiffs' Section 11 allegtions relating to the 1999 7% Exchangeable Notes fail to plead reliance on the prospectus and registration statement for that offering. It also argues that Plaintiffs' are all grounded in fraud but not pleaded with particularity, as required by Rule 9(b). Nor have Plaintiffs pled facts to show that Salomon Smith Barney knew about the alleged

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8 BA argues that an ordinary broker-client relationship does not create a duty to disclose and cites the following cases: *Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 536 (2d Cir. 1999)(in the context of an ordinary broker-client relationship, the broker owes no fiduciary duty to the purchaser of the security"); *Independent Order of Foresters v. Donaldson, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 940 (2d Cir. 1998)(no fiduciary duty is inherent in an ordinary broker/customer relationship); *Yang v. Witter (In re Dean Witter Managed Futures Ltd. Partnership Litig.*, 724 N.Y.S.2d 149, 151 (App. Div. 2001)(dismissing breach of fiduciary duty claim because "plaintiffs have not alleged that they had anything more than ordinary broker-client relationships"); *Liberman v. Worden*, 701 N.Y.S.2d 419, 420-21 (App. Div. 2000)(standard nondiscretionary account does not create a fiduciary relationship between broker and customer"). #15 at 19. On the other hand, BA acknowledges there are cases in which the court finds a narrower fiduciary duty between a broker and client limited to consummating a requested transaction: *See, e.g., Press*, 166 F.3d at 536; *Bissell v. Merrill Lynch & Co.*, 937 F. Supp. 237, 246 (S.D.N.Y. 1996), *affirmed*, 157 F.3d 138 (2d Cir. 1998); *In re Nappy*, Nos. 895-81248-288, 895-8293-288, 1999 WL 33321791, *15 (E.D.N.Y. Oct. 13, 1999)("affair entrusted to a broker who is to buy or sell through an exchange is to execute the order, not to discuss its wisdom"). #15 at 19 n.12. BA maintains that Plaintiffs' "allegation of privity, that Banc of America 'directly sold Enron debt securities to Plaintiffs,'" is not a "special relationship of trust or confidence between the parties" that would have given rise to a duty to support a negligent misrepresentation claim.

wrongdoing by Enron and Arthur Andersen LLP and/or the falsity of Enron's financial statements.

BA additionally argues that the prospectus for the Exchangeable Notes adequately disclosed the risks of the purchase of these notes, i.e., that an Enron Bankruptcy would constitute default; that an Enron bankruptcy could prevent exchange of the notes for EOG common stock, which would be vulnerable to Enron's creditors; that Enron's credit ratings would affect the value of the notes; and that Enron's financial results depended on access to capital markets and credit. The Court finds these arguments irrelevant to the claims actually alleged here. BA also contends that Plaintiffs' negligent misrepresentation claim is barred by New York's Martin Act,[9] which governs fraud and deception in the

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[9] The Martin Act, a/k/a New York's Blue Sky Laws, gives the state's Attorney General exclusive power to regulate and enforce New York's securities laws and, as indicated above, does not provide a private cause of action. General Business Law 352-c(1)(c) in relevant portion prohibits any person, partnership, corporation, trust or association, or any agent or employee thereof, from engaging in

> (a) Any fraud, deception, concealment, suppression, false pretense or fictitious or otherwise pretended purchase or sale;
> (b) Any promise or representation as to the future which is beyond reasonable expectation or unwarranted by existing circumstances;
> (c) Any representation or statement which is false, where the person who made such representation or statement: (i) knew the truth; or (ii) with reasonable effort could have known the truth; or (iii) made no reasonable effort to ascertain the truth; or (iv) did not have knowledge concerning the representation or statement made;
> where engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase within or from this state of any securities . . . .

sale, distribution, exchange and purchase of securities, including claims that do not require proof of intent to defraud, and which a number of courts have held does not permit private right of action for violations of its antifraud provisions. N.Y. Gen. Bus. Law § 352 *et seq.*; *CPC, Int'l, Inc. v. McKesson Corp.*, 70 N.Y.2d 268, 276 (1987); *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 190 (2d Cir. 2001)(upholding dismissal of fiduciary duty claims based on alleged misrepresentation in the sale of securities because allowing such a claim would effectively permit a private right of action under the Martin Act); *Granite Partners, L.P. v. Bear, Stearns & Co.*, 17 F. Supp. 2d 275, 291-92 (S.D.N.Y. 1998)(same; citing cases holding that private actions for negligent misrepresentation are precluded by the Martin Act). Finally BA argues that there is no allegation that Silvercreek Management purchased any of the Enron securities that would give it standing to sue, nor do Plaintiffs plead any facts giving rise to a special relationship between Silvercreek Management and Defendants, nor do they allege facts suggesting that Silvercreek Management ever acted or made a decision in reliance on alleged misstatements or omissions by Defendants.

Insisting that they have adequately pled reliance on the alleged misleading statements, Plaintiffs maintain that they read and primarily relied on the Enron 7% Exchangeable Notes offering memorandum and prospectus prepared by Goldman Sachs and the Zero Note offering memorandum and prospectus prepared by Salomon Smith Barney, especially the presentation of the critical factor of Enron's credit strength and the historical financial information (reiterated by other Wall Street analysts), in view of the underwriter Defendants' purported competence, ability to complete due diligence, and obligation to provide full and accurate disclosure, in deciding to purchase the notes in October 2001. They therefore believed the negative news in October 2001 was merely "financial noise" that was not central to Enron's business or the long-term viability of the company. Plaintiffs emphasize that they were buying debt, not equity, of Enron; their investment depended solely on Enron's staying in business until July 2002, paying interest on its bonds and delivering EOG common shares to the bond holders at that time, and not on the relative, fluctuating values of Enron's stock. Therefore they were focused more on historical performance information, cash flow risk, credit, and repayment cushion to assess the stability and strength of Enron's core business, not the value of its common stock, for protection of the expected return on the investment. With respect to the SEC inquiry, that began on October 22 and escalated into a formal investigation on October 31, 2001, Plaintiffs respond that they were reducing their exposure to the company at that time, that the SEC makes many inquiries, which do not usually cause companies to go into bankruptcy, and that Enron officials and the research analysts from underwriter Defendants continued to reassure investors throughout this period. Although Defendants claim that Plaintiffs increased their Enron investments after Enron announced on November 8, 2001 that it was restating years of financial statements, Plaintiffs respond that they did not purchase Enron bonds that month and that the merger with Dynegy, valued at $23 billion, was announced at the same time. Moreover, Louise Morwick's affidavit (#29) controverts Defendants' contention that Plaintiffs purchased Enron securities in November by stating that the purchases were by her for her own individual Silvercreek account and that she is not a plaintiff.

As for Goldman Sachs' alternative motion to compel arbitration of the common law claims, Plaintiffs contend that these claims are not within the scope of the arbitration clauses in the relevant agreements, attached as Exhibits A-E to Kim Cuomo's affidavit (#63). All except Ex. E, the "Master Letter Non-U.S. Investment Advisor [Silvercreek Management Inc.]" from Silvercreek Management Inc. to Goldman Sachs, are partnership agreements between each Plaintiff [or its predecessor in interest] and Goldman Sachs that state, "This agreement sets forth our respective rights and obligations in connection with your accepting a cash or margin account or accounts for the partnership named herein." The "Master Letter," Ex. E, references accounts "in which we give an order with respect to securities," and appears to refer to the accounts referenced in Exhibits A-D. Plaintiffs insist that none of the claims relates to Goldman Sachs' acceptance of cash or margin accounts. Because the plain language of the agreement makes clear that the claims do not fall within the scope of the agreements, Goldman Sachs cannot force Plaintiffs to arbitrate their dispute merely because public policies favor of arbitration. *Louis Dreyfus Negoce S.A. v. Blystad Shipping*, 252 F.3d 218 (2d Cir. 2001).

Plaintiffs respond that for their fraud and negligent misrepresentation claims, Goldman Sachs had a duty to disclose all material information to them based on the affirmative statements it had made in the registration statements, prospectus, and analyst reports.

APPLICABLE LAW

The Court hereby incorporates the memoranda and orders in *Newby* dealing with motions to dismiss the same causes of action as those asserted here in H-02-3185.

Federal Rule if Civil Procedure 9(b) provides,

> In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge and other condition of mind of a person may be averred generally.

Although "the second sentence . . . relaxes the particularity requirement for conditions of the mind, such as scienter" by permitting them to be "averred generally," the Fifth Circuit has made clear that

> the case law amply demonstrates that pleading scienter requires more than a simple allegation that a defendant had fraudulent intent. To plead scienter adequately, a plaintiff must set forth specific facts that support an inference of fraud. *See Greenstone v. Cambex Corp.*, 975 F.2d 22, 25 (1st Cir. 1992)("The courts have uniformly held inadequate a complaint's general averment of the defendant's 'knowledge' of material falsity, unless the complaint *also* sets forth specific facts that makes it reasonable to believe that defendant knew that a statement was materially false or misleading.")(emphasis in original); *DeLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir.)("Although Rule 9(b) does not require 'particularity' with respect to

> the defendants' mental state, the complaint must still afford a basis for believing that plaintiffs could prove scienter."), *cert. denied*, 498 U.S. 941 . . . (1990). . . .

Tuchman v. DSC Communications Corp., 14 F.3d 1061, 1068 (5th Cir. 1994). Moreover, the panel explained,

> The factual background adequate for an inference of fraudulent intent can be satisfied by alleging facts that show a defendant's motive to commit securities fraud. Where a defendant's motive is not apparent, a plaintiff may adequately plead scienter by identifying circumstances that indicate conscious behavior on the part of the defendant, though the strength of the circumstantial allegations must be correspondingly greater. [citation omitted]

Id.[10] Nevertheless, an increase in compensation is an insufficient incentive for alleging fraudulent intent for securities fraud "because virtually every corporation in the United States would be subject to fraud allegations." *Id.* at 1068-69.

A plaintiff states a claim under Section 11, 15 U.S.C. § 77(k)(a), if he alleges that he purchased a security and that the registration statement contained a false or misleading statement regarding a material fact. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381-82 (1983)("Section 11 of the 1933 Act allows purchasers of a registered security to sue certain enumerated parties [the issuer, its directors or partners, underwriters and accountants who are named as having prepared or certified the registration statement] in a registered offering

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[10] The Court points out that *Tuchman* issued prior to the enactment of the Private Securities Litigation Reform Act of 1995 ("PSLRA") with its heightened pleading requirements and thus relates to Rule 9(b) standards applied to securities fraud claims generally.

when false or misleading information is included in a registration statement."). Unlike under § 10(b), under § 11 the plaintiff generally does not have to establish scienter,[11] causation (materiality) or reliance. *Id.* at 382; *Shaw v. Digital Equipment Corp.*, 82 F.3d 1194, 1222 (1st Cir. 1996); *Alpern v. Utilicorp United, Inc.*, 84 F.3d 1525, 1541 (8th Cir. 1996).

Title 15 U.S.C. § 77k(a), providing a statutory exception to the usual rule that reliance is not required for a § 11 claim, states that a plaintiff who purchases a security "after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person."

Under 17 C.F.R. § 230.158, the term "effective date" in this final paragraph is defined as follows:

> For purposes of the last paragraph of section 11(a) only, the "effective date of the last registration statement" is deemed to be the date of the latest to occur of (1) the effective date of the registration statement:

[11] The sole exception to the no-scienter requirement is that under § 27A(c) of the PSLRA, to impose liability on a defendant for "forward-looking" statements, a plaintiff must demonstrate that the speaker or approving officer had actual knowledge of the false and misleading statement made on behalf of the corporation. 15 U.S.C. §77z-2(c)(1)(B)(i).

(2) the effective date of the last post-effective amendment to the registration statement, next preceding a particular sale by the registrant of registered securities to the public filed for purposes of (i) including any prospectus required by section 10(a)(3) of the Act, (ii) reflecting in the prospectus any facts or events arising after the effective date of the registration statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement, or (iii) including any material information with respect to the plan or distribution not previously disclosed in this registration statement or any material change to such information in the registration statement, or (3) the date of filing of the last report of the registrant incorporated by reference into the prospectus, and relied upon in lieu of filing a post-effective amendment for purposes of paragraphs (c)(2)(i) and (ii) of this rule, next preceding a particular sale by the registrant of registered securities to the public.

Because Plaintiffs bought their Exchangeable Notes beginning on October 24, 2001 (two and a half years after the prospectus issued and three to four years after the financial statements included in the prospectus were made public) and because Goldman Sachs contends that Plaintiffs fail to identify any misrepresentation by Goldman about the Zero Coupon notes, Goldman Sachs argues that Plaintiffs must allege with factual specificity actual reliance on Enron's 1997 and 1998 financial statements included in the 1999 prospectus for these debt securities. It insists they cannot do so.

Under New York common law, to plead a *prima facie* case of fraud, a plaintiff must allege with supporting facts that "(1) the defendant made material representations that were false, (2) the defendant knew the representations were false[12] and made them with the intent to deceive the plaintiff, (3) the plaintiff justifiably relied on the defendant's representations, and (4) the plaintiff was injured as a result of the defendant's representations." *Cohen v. Houseconnect Realty Corp.*, 289 A.D.2d 277, 278, 734 N.Y.S.2d 205, 206 (N.Y.A.D. 2 Dep't 2001); 60A N.Y. Jur.2d *Fraud and Deceit* § 138.

"Reliance and the existence of a special relationship between the parties are two distinct elements of a negligent misrepresentation claim." *Ravenna v. Christie's Inc.*, 289 A.D.2d 15, 16, 734 N.Y.S.2d 21, 22 (N.Y.A.D. 1 Dep't 2001), *citing Hudson River Club v. Consolidated Edison Co.*, 275 A.D.2d 218, 220, 712 N.Y.S.2d 104 (N.Y.A.D. 1 Dep't 2000). New York law requires that for a plaintiff to state a claim for negligent misrepresentation, he must allege that there is "'a special relationship of trust or confidence that creates a duty for one party to impart correct information to another, the information given was false, and there was reasonable reliance upon the information given.'" *H&R Project Associates, Inc. v. City of Syracuse*, 289 A.D.2d 967, 969, 737 N.Y.S.2d 712, 715 (N.Y.A.D. 4 Dep't 2001), *quoting Hudson River Club v. Consolidated Edison Co.*, 275 A.D.2d 218, 220, 712 N.Y.S.2d 104 (N.Y.A.D. 1 Dep't 2000). The plaintiff must show "either actual privity of contract between the parties or a relationship so close as to approach that of privity." *Solandz v. Barash*, 225

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[12] In Texas, the requirements are more lenient in that the misrepresentation may be made with knowledge of its falsity *or* made recklessly without knowledge of its truth. *American Tobacco Co. Inc. v. Grinell*, 951 S.W.2d 420, 436 (Tex. 1997).

A.D.2d 996, 998, 639 N.Y.S.2d 561, 564 (N.Y.A.D. 3 Dep't 1996). "A 'special relationship' requires a closer degree of trust than an ordinary business relationship." *Id.* Where such a relationship is shown to exist, one party has a duty to provide accurate information to the other; if he provides incorrect information to the other and the other party reasonably relies on it to his detriment, the other party may sue for negligent misrepresentation. *Id.* The mere fact that one party providing information is aware that the plaintiff would rely on his information is insufficient to state a claim. *Ravenna*, 289 A.D.2d at 16, 734 N.Y.S.2d at 22. As phrased by one appellate court,

> There may be liability for negligent misrepresentation where there is a relationship between the parties such that there is an awareness that the information provided is to be relied upon for a particular purposes by a known party in furtherance of that purpose, and some conduct by the declarant linking it to the relying party and evincing the declarant's understanding of their reliance. . . . To state it somewhat more succinctly, the relying party "must have been a person for whose use the representation was intended" or "he must at least have been a member of some very small group of persons for whose guidance the representation was made."

Houlihan/Lawrence, Inc. v. Duval, 228 A.D.2d 560, 561, 644 N.Y.S.2d 553 (N.Y.A.D. 2 Dep't 1996). *See also Osuchowski v. Gallinger Real Estate*, 273 A.D.2d 892, 893, 711 N.Y.S.2d 369 (quoting *Houlihan/Lawrence*).

The complaint states that BA and Salomon Smith Barney provided brokerage services to Plaintiffs in purchasing their notes. It is black letter New York law that a stockbroker who buys and sells securities for a client in the usual conduct of business does not owe a general fiduciary duty to the purchaser of the securities. *Independent Order of Foresters Donaldson, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 940 (2d Cir. 1998)("Under New York law . . . there is no general fiduciary duty inherent in an ordinary broker/customer relationship."); *Rush v. Oppenheimer & Co., Inc.*, 681 F. Supp. 1045, 1055 (S.D.N.Y. 1988)("the mere existence of a broker-customer relationship is not proof of its fiduciary character . . . . Instead a fiduciary duty arises where the customer entrusts to the broker 'matters beyond the individual transaction in his account'"); *Fekety v. Gruntal & Co.*, 191 A.D.2d 370, 371, 595 N.Y.S.2d 190 (N.Y.A.D. 1 Dep't 1993)("a broker does not, in the ordinary course of business, owe a fiduciary duty to a purchaser of securities"). An exception occurs if the client gives discretionary trading authority to the broker, not an issue in this action. *Independent Order*, 157 F.3d at 940-42 (where client has a nondiscretionary account, broker's obligations relate only to a duty to exercise trades as directed and notifying client before executing such transactions in his account; he does not have a general fiduciary duty to advise the client of risks of certain purchases); *Rush*, 681 F. Supp. at 1055.

Although there is no fiduciary duty in this context, however, there is still a duty owed by a stockbroker to a nondiscretionary client. *De Kwiatkowski v. Bear, Stearns & Co., Inc.*, 306 F.3d 1293, 1302 (2d Cir. 2002). The Second Circuit has stated,

> It is uncontested that a broker ordinarily has no duty to monitor a nondiscretionary account, or to give advice to such a customer on an ongoing basis. The broker's duties ordinarily end after each transaction is done and thus do not include a duty to offer unsolicited information, advice or warnings concerning the customer's investments. A nondiscretionary customer by definition keeps control over the account and has full responsibility for trading decisions. On a transaction-by-transaction basis, the broker owes duties of diligence and competence in executing the client's trade orders, **and is obliged to give honest and complete information when recommending a purchase or sale**. The client may enjoy the broker's advice and recommendations with respect to a given trade, but has no legal claim on the broker's ongoing attention.

Id. at 1302 (emphasis added). Here the issue is not ongoing attention over a long relationship, but the recommendation with respect Plaintiffs' purchase of the Enron debt securities during a very narrow period in October 2001, which may well perceived as a one or two transactions by each Plaintiff.[13]

APPLICATION OF LAW TO PLEADINGS

First, the Court finds that Plaintiffs have adequately pled reasons why the targeted statements (in the offering memoranda, prospectuses, and registration statements of the notes

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[13] Specifically, according to the amended complaint at 39-30, ¶ 108, Plaintiff Silvercreek II Ltd. bought Exchangeable Notes on October 24 and 25, 2001 and Zero Coupon Notes from October 18-26, 2001; Plaintiff OIP Ltd. bought Exchangeable Notes from Oct. 24-26, 2001 and Zero Coupon Notes from October 19-24, 2001; Plaintiff Pebble Ltd. Partnership purchased Exchangeable Notes on October 24 and 26, 2001 and Zero Coupon Notes from October 19-24; Plaintiff Silvercreek Ltd. Partnership purchased Exchange Notes on October 24-25, 2001 and Zero Coupon Notes from October 19-21, 2001.

at issue, as well as Enron's annual and quarterly financial statements that were incorporated in them, and various analyst reports and recommendations) were materially false and misleading by the amended complaint's numerous allegations of direct involvement in an extensive network of deliberately complicated off-the-books transactions by the same Defendant entities, involving sham hedging, loans disguised as sales, prepays, etc., effected through conflicted special purpose entities created to inflate Enron's earnings and conceal debt. For the same reasons Plaintiffs have pled sufficiently that Defendants' continuing positive analyst reports and recommendations that investors purchase Enron securities were also materially false and misleading.

As one of the elements of common law fraud under New York law and Federal Rule of Civil Procedure 9(b), Plaintiffs must also allege particular facts that reasonably imply that defendant knew that the challenged statements were materially false or misleading at the time they made them. Some of the underwriter Defendants' objections to insufficiencies in the pleading of the fraud claim have been cured by Plaintiffs' first amended complaint. The Court examines the allegations in the amended complaint against each objecting Defendant to determine whether Plaintiffs have adequately pled that each Defendant knew that his statements were false and misleading at the time they were issued.

Asserting that all three underwriter Defendants had long-term relationships with Enron that earned them substantial fees, the amended complaint attempts to describe the roles beyond standard underwriting service that these Defendants, themselves, played in the alleged fraudulent scheme, i.e., participatory conduct sufficient to reasonable infer they had knowledge of enough of the purported scheme for them to be conscious that their representations to the public about Enron's financial stability were materially misleading and false, evidencing Defendants' own intent to deceive. Plaintiffs' amended pleading tries to demonstrate particularly and concretely the earlier complaint's conclusory statement that the underwriter Defendants "provided professional services to Enron, and were very familiar with all the financial dealings of Enron." Nevertheless many allegations remain general and conclusory.

The superseding pleading alleges that Defendants operated without adequate "Chinese walls" and participated in preparation of the offering memoranda and prospectuses, which incorporated financial statements that they knew were false from their access to confidential records reflecting Enron's "touch-and-go financial position," as well as provided false and misleading analysts reports and recommendations. They are also charged with failing to adequately conduct their due diligence review of Enron prior to issuance of the debt securities in dispute.

Citigroup/Salomon Smith Barney "provided commercial and investment banking services, commercial loans and advisory services regarding the structuring of financial transactions, including those relating to derivatives and hedging, to Enron . . . [and] acted as an underwriter in the sale of securities to the public and provided investment analysis and opinions through reports by its securities analysts," while collecting substantial fees, including $20 million in 2000 alone. Amended Complaint at 84, ¶ 216. According to Plaintiffs, like BA, Salomon Smith Barney served as Plaintiffs' stock brokerage and thus had privity and/or a "special relationship" giving rise a duty to disclose correct information for purposes of Plaintiffs' common-law negligent misrepresentation claim. Among the specific activities chronicled in the new pleading to demonstrate Citigroup/Salomon Smith Barney's direct and substantial involvement in the Enron scheme, many of which are also targeted by Lead Plaintiff's complaint in *Newby*, the complaint asserts that Citigroup/Salomon Smith Barney participated personally and extensively in a number of illicit transactions with or for Enron, including the following: Citigroup/Salomon Smith Barney's central role in structuring and financing the now infamous LJM2 partnership at a time when cash from its transactions was critical to Enron to meet its Wall Street profit forecasts and continue to prop up the artificially inflated price of its stock; involvement in the Bacchus transactions (see U.S. Senate Permanent Subcommittee on Investigations Staff Report on Fishtail, Bacchus, Sundance and Slapshot, Ex. A[14] to the Amended Complaint, all allegedly funded by

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[14] The Report at 1 describes four large finance transactions called Fishtail, Bacchus, Sundance and Slapshot, Enron's business venture in pulp and paper trading between December 2000 and June 2001. The report states that the evidence demonstrates that Citigroup/Salomon Smith Barney, along with J.P. Morgan Chase & Co., "actively aided Enron in these transactions, despite knowing the transactions utilized deceptive accounting or tax strategies and favorable consideration in other business

Citigroup/Salomon Smith Barney), transactions beginning in December 2000 which give rise to a reasonable inference that Citigroup/Salomon Smith Barney knew they were being used to manipulate Enron's financial statements[15]; the financing of and securitization for transactions for Northern Border Partners, LP, controlled by Enron; the 1999 Roosevelt deal, in which Citigroup

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deals. The evidence also indicates that Enron would not have been able to complete any of these transactions without the direct support and participation of a major financial institution." The Report goes on to detail how the four transactions were used to perpetrate fraud on the market and the investing public.

The Court notes that the Appendixes to Exhibit B to the Amended Complaint reference evidence and detail Citigroup/Salomon Smith Barney's substantial and knowing role in a number of Enron's fraudulent prepays, used to inflate its earnings and hide its debt on financial statements. See Amended Complaint at 74-78, ¶¶ 191-198.

[15] The complaint at 71, ¶ 184, quotes the Subcommittee Report's discussion of the Bacchus transaction, which

> arranged for a shell company to borrow $200 million from Citigroup to "purchase" Enron's Fishtail interest, without disclosing that Enron was guaranteeing the full purchase price; used the sham sale revenue to inflate its year-end 2000 earnings by $112 million; and then quietly returned the $200 million to Citigroup six months later via another sham joint venture, Sundance. The result was that the three transactions enable Enron to produce misleading financial statements that made Enron's financial condition appear better than it was.

The complaint at 72-73, ¶¶ 186 and 187, alleges that Citigroup/Salomon Smith Barney contributed $200 million in funding in a disguised loan to these transactions, received back a $500,000 fee, $5 million in interest payments and $450,000 in "yield" for a $6 million "equity investment." In the Sundance transaction alone it received as "breakage costs" a $1.5 million payment, a fee of $725,000, and a $1.1 million return on its investment. The Subcommittee report describes internal memos and e-mails evidencing Citigroup/Salmon Smith Barney's awareness of the fraudulent nature of these transactions.

senior credit officers misrepresented the transaction and manipulated the written record to leave $125 million of Enron debt off its balance sheet; with other banks, underwriting the Osprey Trust, which funded fraudulent sales by Enron's unconsolidated Whitewing Associates LLP, moving "at least $2 billion in underperforming assets off Enron's balance sheet,"[16] that the underwriters chose not to disclose in Enron's registration statements or research reports; providing Enron with a $1 billion overdraft authorization to aid Enron in effectuating the Slapshot (fraudulent tax avoidance) transaction (Ex. A to the Amended Complaint); SPE Rhythms Netconnections Inc.'s off-the-books transactions; setting up and participating in the shell corporation Delta, controlled by Citigroup, to disguise debt and to inflate cash flow through prepaid swaps; preparation of various internal reports for Enron, which reflect that Citigroup/Salomon Smith Barney knew that Enron's indebtedness was substantially greater than what was reported in Enron's financial statements; creation of the fraudulent Yosemite transactions, which unknown to Yosemite investors, used Yosemite proceeds to fund Enron prepays, not for buying revenue-producing assets; taking New Power, Inc. public to create a market for its shares, in turn to create a "profit" by a sham sale to SPE Hawaii 125-0, funded by a loan from Citigroup/Salomon Smith Barney, secretly guaranteed by Enron, i.e., a total return swap; and a number of "transactions" that were loans, guaranteed by Enron so there was no risk to the

[16] Amended Complaint at 87, ¶ 223.

lender, disguised as sales to mislead investors. Particular allegations of such direct, extensive involvement in significant fraudulent transactions are sufficient to give rise to a reasonable inference that Citigroup/Salmon Smith Barney was aware that the statements in the prospectuses and registration statements and its own public recommendations of Enron's securities through October of 2001 were false and misleading.

Regarding BA by itself, the amended complaint cites BA's participation in structuring and pre-funding of LJM2 and in the resulting "tremendous profits"; conclusorily references its underwriting of the Marlin transactions, with the lack of disclosure of Enron's potential obligations to back these entities if Enron stock prices fell to specified levels (which were not disclosed in the Exchangeable Note or Zero Coupon Note prospectuses); mentions vaguely BA's support for the LJM entities; and a characterization, without clear explanation, of a purportedly sham sale of Enron pipeline and gas assets to SPE Bammel Gas Trust and a secret swap agreement to inflate revenue and cash flow and understate liabilities. These few, nonspecific allegations reference conduct typical of an investment bank's professional services and are too general and vague to reasonably imply that BA knew about the alleged fraud and that the financial statements and offering memoranda and prospectuses were false when issued.

The allegations against Goldman Sachs also fail to allege facts constituting specific involvement that would imply that it knew that Enron's financial statements were false and misleading. The complaint conclusorily states that the various allegedly fraudulent financial statements at issue, by which Enron and Arthur Andersen "cooked Enron's books," were reviewed by Goldman Sachs as part of its due diligence review. Goldman Sachs is accused of knowledge of Enron's extensive off-balance-sheet activities and hidden loans because of its representation of a German utility company, Veba, which considered merging with Enron in the late 1990's (before the filing of the 7% Exchangeable Notes prospectus) until Veba realized how troubling Enron's finances and accounting practices were and backed out of the merger. Plaintiffs do not identify exactly what Veba and Goldman discovered or how and where. The allegations that since 1986 Goldman Sachs earned more underwriting fees from Enron than any other entity, that it developed a controversial tax strategy known as "trust preferred securities and underwrote a Monthly Income Preferred Shares/Securities investment deal for Enron (no specifics provided), that it proposed taking Yosemite public, that it worked on hidden loans and was aware of Enron's extensive off-balance sheet activities (but without any specifics), and that it recently settled with various regulatory agencies relating to its challenged research bias and conflicts of interest in its securities analyses and recommendations, are too vague and general as circumstantial fact allegations in the amended complaint to establish scienter.

With respect to all three Defendants' contentions that Plaintiffs have failed to plead reliance for their fraud and negligent misrepresentation claims, the amended complaint at 40,

¶ 109 states that Plaintiffs purchased the Zero Coupon Notes within one year of issuance of the registration statement[17]; therefore there is a presumption of reliance and they need not allege facts demonstrating actual reliance for those notes under 15 U.S.C. §77k(a). Furthermore the Court finds that Plaintiffs have sufficiently pled reasonable and justifiable reliance on the offering memoranda and prospectuses of the two notes at issue and on Defendants' numerous glowing recommendations of Enron's securities to the public. They have provided a reasonable justification in their explanation of the difference in focus of debt investors versus equity investors and the significance of historical financial information, as well as current fluctuations, to the former because the critical risk was solely whether Enron, seventh on the Fortune five hundred list of the United States' biggest companies, would remain solvent during the few months until the notes matured. Indeed, a company's annual and quarterly financial statements filed with the SEC and incorporated into the offering memoranda and prospectuses of the notes, in accordance with their *raison d'etre*, are standardly used by the market to, and here allegedly constituted Plaintiffs' primary sources for historical information, to gauge Enron's long-term financial stability, the critical factor in evaluating the risk for debt securities. Plaintiffs have alleged that they relied on what turned out to be materially false and misleading financial statements, which induced them, along with the continuing

[17] The prospectus for the Zero Coupons was dated July 25, 2001 with supplements dated up to October 12, 2001.

recommendations to buy Enron securities throughout October 2001 from the underwriter Defendants, known for their professional expertise and superior reputations, to do just that.

Furthermore, Plaintiffs have also raised fact issues, not properly resolved on a motion to dismiss, regarding Defendants' arguments that Plaintiffs' sophistication, their alleged arbitrage strategy, and the negative information publicly available at the time they purchased their notes, defeat their claim of reasonable and justifiable reliance.

A cause of action for negligent misrepresentation under New York law requires allegations by the Plaintiffs of facts showing a special relationship between Defendants and Plaintiffs, or stockbrokers and their clients, that created an obligation on at least BA and Salomon Smith Barney's part to present correct information to Plaintiffs. As noted, under New York law despite the privity between stockbroker and client, "a broker does not, in the ordinary course of business, owe a fiduciary duty to a purchaser of securities." *Fekety v. Gruntal & Co.*, 191 A.D.2d 370, 371, 595 N.Y.S.2d 190 (N.Y.A.D. 1 Dep't 1993). Nevertheless, according to the Second Circuit, under New York law in nondiscretionary account transactions, "On a transaction-by-transaction basis, the broker owes duties of diligence and competence in executing the client's trade orders, and is obliged to give honest and complete information when recommending a purchase or sale." *De Kwiatkowski*, 306 F.3d at 1302. Plaintiffs allegations that BA and Citigroup/Salomon Smith Barney failed to conduct due diligence in investigating and failed to give complete and accurate information while providing brokerage services relating to Plaintiffs' purchases of the Enron notes during a brief period in October 2001 are sufficient to state a claim for negligent misrepresentation against these two entities, but not against Goldman Sachs.[18]

Nevertheless, the negligent misrepresentation claim against BA and Citigroup/Salomon Smith Barney is barred for another reason. As noted, while Plaintiffs have not asserted and cannot state a claim action under New York's Martin Act, General Business Law § 352-c, because the Act has no express or implied private right of action, *CPC International*, 70 N.Y.2d at 286-87, the New York Court of Appeals has not addressed, and there is a split of opinion among New York's lower courts, whether the Act preempts claims by plaintiffs made under common law. *See, e.g.*, *Suez Equity Investors L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 104 (2d Cir. 2001). In *CPC International*, for instance, the court allowed plaintiffs to pursue a common law claim for fraud in a securities context. *See also, e.g.*, *Scalp & Blade, Inc. v. Advest, Inc.*, 722 N.Y.S.2d 639, 640 (4th Dep't 2001)(upholding claim for negligent misrepresentation and stating, "Nothing in the Martin Act, or the Court of Appeals cases construing it, precludes a plaintiff from maintaining common-law causes of action based on such facts as might give the Attorney-General a basis for proceeding civilly or criminally against a defendant under the

[18] There are no allegations of a special relationship based on the agreements submitted by Goldman Sachs, attached to Cuomo's affidavit, nor is Goldman Sachs charged with providing brokerage services to Plaintiffs.

Martin Act."); *Ansonia Tenants' Coalition, Inc. v. Ansonia Associates*, 151 Misc.2d 213, 573 N.Y.S.2d 211 (N.Y. Sup. 1991)(" . . . [D]enial of a private right of action under the Martin Act in no way precludes a plaintiff from raising a claim of common law fraud alleging actionable wrongs independent of any requirements of the Martin Act, wrongs such as any plaintiff may have raised prior to the enactment of the Martin Act . . . .", *aff'd*, 179 A.D.2d 594, 580 N.Y.S.2d 649 (N.Y.A.D. 1 Dept. 1992). Nevertheless a majority of courts have held otherwise. *See, e.g., Horn v. 440 East 57th Co.*, 547 N.Y.S.2d 1, 5 (1st Dep't 1989)(upholding common law fraud claim but dismissing claims for negligent misrepresentation and breach of fiduciary duty as precluded by Martin Act because "to sustain them would be, in effect, to recognize a private cause of action under the Martin Act"); *Rego Park Gardens Owners, Inc. v. Rego Park Gardens Assocs.*, 595 N.Y.S.2d 492, 494 (2d Dep't 1993)(relying on *Horn* in dismissing claim for negligent misrepresentation); *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 190-91 (2d Cir. 2001)(dismissing claim for breach of fiduciary duty); *Granite Partners*, 17 F. Supp. 2d at 91-92; *Whitehall Tenants Corp. v. Estate of Robert S. Olnick*, 213 A.D.2d 200, 200, 623 N.Y.S.2d 585, 585 (N.Y.A.D. 1 Dept. 1995)("While CPC . . ., holding that there is no private right of action under the Martin Act, does not foreclose a cause of action for common-law fraud . . ., private plaintiffs will not be permitted through artful pleading to press any claim based on the sort of wrong given over to the Attorney

General under the Martin Act."), appeal denied, 86 N.Y.2d 704, 655 N.E.2d 705, 631 N.Y.S.2d 608 (1995)(Table).

Many of the cases dismissing common-law claims are progeny of *Horn*. In *dicta* the Second Circuit has previously voiced skepticism about *Horn's* lack of reasoning to support its holding. *Suez Equity*, 250 F.3d at 104 (although refusing to address the preclusion issue because it was raised for the first time on appeal, the panel nevertheless observed that it was "not immediately persuaded that the Court of Appeals would follow the[] lead" of *Rego Park* and *Horn* decisions because these decisions "do not explore the issue with the level of depth" required; also questioning their failure to distinguish between their allowance of a common law fraud claim, but disallowance of a negligent misrepresentation claim). *See also Cromer Fin. Ltd. v. Berger*, No. 00 CIV 2498, 2001 WL 1112548, *4 and n.6 (S.D.N.Y. Sept. 19, 2001)(examining *Suez Equity* and *Scalp & Blade* and concluding that the Second Circuit when next addressing the issue and the split of opinion among the state's appellate courts, would adopt the analysis in *Scalp & Blade*, 722 N.Y.S.2d at 640 ("Nothing in the Martin Act or in the Court of Appeals cases construing it, precludes a plaintiff from maintaining common-law causes of action based on such facts as might give the Attorney-General a basis for proceeding civilly or criminally . . . under the Martin Act.")).

Nevertheless, after *Suez Equity*, another Second Circuit panel did follow the rule of *Horn* and not that of *Scalp & Blade*. *Castellano*, 257 F.3d 190-91. Furthermore, as articulated in *Nanopierce Technologies, Inc. v. Southridge Capital Management*

LLC, No. 02 CIV 0767 (LBS), 2003 WL 22052894, *4 (S.D.N.Y. Sept. 2, 2003), contrary to the objections in *Suez Canal* a logical and persuasive rationale is expressly presented by the *Horn* line of cases for the distinction in allowing common law fraud claims to proceed while finding negligent misrepresentation and breach of fiduciary duty claims preempted by the Martin Act:

> The latter two causes of action, like the Martin Act itself, do not require proof of deceitful intent; common law fraud, however, does. Courts concerned with preserving the Attorney General's exclusive domain therefore preclude claims which essentially mimic the Martin Act, but permit common law fraud claims, which require an additional element.

Id., *citing Horn*, 151 N.Y.S.2d at 5; *Whitehall*, 623 N.Y.S.2d at 585; *Granite Partners*, 17 F. Supp.2d at 291-92. This Court accordingly concludes that Plaintiffs' negligent misrepresentation cause of action against all Defendants is barred, but the fraud claim against Citigroup/Salomon Smith Barney is not.

The amended pleading expressly states that Plaintiffs' section 11 claims relating to the Exchangeable Notes (Count Two of the Amended Complaint) and the Zero Coupon Notes (Count Four)[19] against all three Underwriter Defendants do "not sound in fraud," and therefore Rule 9(b)'s requirement of pleading with particularity does not apply. *Lone Star Ladies Investment Club v.*

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[19] Count IV characterizes Defendants as "statutory underwriters." *See* the Court's memorandum and order of November 12, 2003 at 24-34, incorporated herein, for discussion of a statutory underwriter under section 11: #1832 in *Newby*, H-01-3624; #650 in *Tittle*, H-01-3913; and #61 in H-02-0851.

Schlotzky's Inc., 238 F.3d 363, 369 (5th Cir. 2001).[20] The Court finds that Plaintiffs have stated claims under section 11 against all three underwriter Defendants relating to both notes.

Thus for the reasons stated above, this Court finds that under New York law, Plaintiff's common law "fraud and deceit" claim against Citigroup/Salomon Smith Barney for its knowing and intentional involvement in preparing the offering memoranda and prospectuses that materially misrepresented Enron's financial condition and in publicly recommending purchase of the notes in the alleged scheme to defraud prospective purchasers of the notes may proceed, but not their fraud claims against BA and Goldman Sachs. Plaintiffs' cause of action for negligent misrepresentation is precluded by the Martin Act. The Section 11 claims against all three Underwriter Defendants are adequately pled.

Accordingly for the reasons indicated above, the Court

ORDERS that Goldman Sachs' motion to supplement (#1312 in *Newby*; #62 in H-02-3185) is GRANTED. The Court further

ORDERS that as to Plaintiffs' claims of common-law fraud, Salomon Smith Barney's motion for an order to dismiss (#10) is DENIED, but Goldman Sachs' motion to dismiss (#7) and BA's

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[20] Indeed, the law in federal district courts in New York holds that Rule 9(b) does not apply to Section 11 claims because section 11 has no fraud requirement. *Fischman v. Raytheon Manufacturing Co.*, 188 F.2d 783, 786 (2d Cir. 1951); *In re In-Store Advertising Securities Litigation*, 878 F. Supp. 645, 650 (S.D.N.Y. 1995); *In re Lilco Sec. Litig.*, 625 F. Supp. 1500, 1503 (E.D.N.Y. 1986). Moreover, Plaintiffs have alleged the elements necessary for section 11 claims against Defendants, both as traditional and as statutory underwriters.

motion to dismiss (#14) in H-02-3185 are GRANTED. As to the common-law negligent misrepresentation claims, all three underwriter Defendants' motions to dismiss GRANTED. Because the fraud and negligent misrepresentation claims against Goldman Sachs are dismissed, its alternative motion to compel arbitration (#7) is MOOT. Finally, as to the § 11 claims, all three motions to dismiss are DENIED.

Plaintiffs' unchallenged claims under § 10(b) and § 20(a) of the Securities and Exchange Act of 1934 and the Texas Securities Act also remain pending.

SIGNED at Houston, Texas, this 10th day of December, 2003.

Melinda Harmon

MELINDA HARMON
UNITED STATES DISTRICT JUDGE